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# SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach

*John C. Burton\**

## I. THE PHILOSOPHY

The enforcement program of the Securities and Exchange Commission is an important means by which the Commission moves towards the objectives of improved capital markets and the prevention of fraud. The regulatory authority under which the Commission is authorized to perform its enforcement activities prescribes that where "it appears that there may be violation of the acts administered by the Commission or the rules and regulations thereunder, a preliminary investigation is generally made."<sup>1</sup> If, as a result of this investigation, it appears that a violation has been or is about to be committed, the Commission may then order a formal investigation.<sup>2</sup> If the investigation reveals that a violation has taken place the Commission can institute administrative proceedings looking to the imposition of remedial sanctions, initiate injunctive proceedings, or refer cases to the Department of Justice for criminal prosecution.<sup>3</sup> Thus, except for this last alternative, the SEC enforcement program is designed to maintain the integrity of the market place and deter fraud, rather than to punish wrongdoers.

While the regulatory language is clear and its authorizations broad, the Commission has limited resources and finds it impossible to investigate and prosecute every violation. Consequently, the Commission has sought in recent years to focus its enforcement efforts at key points where maximum impact can be achieved. For this reason, enforcement efforts involving professionals, such as accountants and lawyers, have been important even though the number of cases in which professionals were so involved has not been great. The reasoning of the Commission is simple: these professionals are an essential element in providing access to the market place,

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\*Chief Accountant, Securities and Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

1. 17 C.F.R. § 202.5 (1974).
2. *Id.*
3. *Id.*

since the sale of securities cannot take place without their involvement. Professional responsibility at these points of access can prevent many questionable activities before they occur.

The enforcement program as it relates to professional accountants, therefore, is part of the Commission's broad effort to encourage improved professional performance. By insisting upon high standards of performance by accountants, more reliable and meaningful financial information for the investing public will be assured. This information is the cornerstone of the analytical process whereby sound investment decisions can be made.

It must be understood that enforcement is only one part of the Commission's program to improve the quantity and quality of information available to the public. The regulatory authority granted the Commission is used extensively, and the potential of its further use has proved a valuable incentive to the development of corrective institutions within the private sector. Regulation and exhortation alone, however, are not enough. An enforcement program has proved to be an essential ingredient in the process and it must be understood as such.

It should be emphasized that the enforcement program is not used as a vehicle by which fundamentally new professional standards are established. The present generally accepted auditing standards of adequate technical training, independence of mental attitude, due professional care, adequate planning and supervision and sufficient competent evidential matter, are perfectly adequate to assure sound auditing if conscientiously applied to each case.<sup>4</sup> In addition, the fundamental accounting principle of fair presentation under the particular circumstances of each case remains the basis for good financial reporting.

## II. THE OBJECTIVES

### A. *Giving Effect to Auditing Standards*

Within the above broad standards the Commission's enforcement program deters shoddy performance by the increased risk of a Commission injunctive action and private actions for money damages.

As a result it becomes desirable for individuals and firms to devote greater resources and more care to the avoidance of such performance. While professionals in general have a desire to do a good job, excellence is costly, and in a world of competing claims

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4. See 1 CCH AICPA PROF. STANDS., SAS No. 1, AU § 150.02 (1972).

and equities, a program which raises the cost of deficient work should have the impact of improving performance. On an individual firm basis, an injunctive action should restrain a repetition of the conduct in question and require improved compliance with professional standards while subjecting those responsible to prosecution if there is a repetition of the unacceptable behavior. On a profession-wide basis, the threat of an enforcement action and the costs of an adverse determination by a court—unfavorable publicity, possible civil judgments, the financial burden of litigation, and, ultimately, a loss of professional stature with a consequent decline in business—all combine to reduce the likelihood of defective professional performance.

### *B. Encouragement of Quality Control Procedures*

It is also intended that the Commission enforcement actions encourage the implementation of profession-wide quality controls within firms. Examples of these initial controls are: procedures involving recruitment, training and promotion of a highly competent professional staff, specific review procedures governing engagements, and internal audit systems by which the management of a firm can be assured these controls are working adequately. In recent years, accounting firms have been devoting substantial resources to all of these types of procedures, and professional standards are giving recognition to their importance.<sup>5</sup>

General procedures assuring adequate professional staff probably are of the greatest importance, because competent, well-trained professionals with an alert and independent attitude are the key to effective auditing. If the staff in the field and the partner in charge of an engagement do not have these attributes, it is unlikely that specific review procedures will provide assurance of a good audit.

On the other hand, well designed review procedures are useful in reducing the danger to the public and the firm of an error or faulty judgment by one or a few individuals. These procedures should be designed to disclose breakdowns within the audit and provide a mechanism for their correction before a report is issued. They may include formal steps by which various levels of workpaper review are undertaken by audit personnel on an engagement. Additional procedures include: provisions for consultation as problems arise, a means by which staff persons who disagree with judgments reached by an engagement partner may bring these matters to the

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5. See, e.g., AICPA SAS No. 4, "Quality Control Considerations for a Firm of Independent Auditors," Dec. 1974.

attention of senior persons in the firm; independent reviews of financial statements and summary workpapers by a partner or technical staff member not directly responsible for the engagement; and the use of industry specialists.

Finally, quality control systems within firms include an after the fact "internal audit" system designed to provide assurance to the management of the firm that adequate audits are being done and that timely review procedures are achieving their objectives. This system normally encompasses post-audit reviews on a sample basis utilizing personnel from other offices or a designated central quality assurance group for the firm as a whole.

In response to Commission actions, actions by private litigants, and some generally perceived public concern about the adequacy of audits, accounting firms have been increasing substantially their commitment of resources to all forms of improved quality controls. It is hoped that this investment will result in fewer auditing errors and a substantial reduction in the frequency of future enforcement actions. In those cases in which errors still occur, review procedures will lessen the likelihood that these errors will go undetected and result in the auditor's acceptance of misleading financial reporting.

### *C. Improving Auditing Standards*

In addition to encouraging better quality controls, enforcement actions may have the benefit of directing attention to areas in which auditing standards may be more effectively articulated and applied. Although Commission actions are based on the facts of particular cases, in some situations the facts may be typical of general problem areas, and Commission opinions, orders, and complaints may emphasize audit deficiencies that require profession-wide attention.

In one recent opinion,<sup>6</sup> for example, the Commission set forth in considerable detail its view of a deficient audit in which transactions with related parties played a major role. In the same opinion, comments were made by the Commission with respect to relationships between predecessor and successor auditors that the Commission believed were inadequate in the particular case. Both areas are now being considered by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants [AICPA], which is attempting to articulate specific guidelines to be applied in these areas. In addition, the Commission's emphasis, in a number of cases, on overall fairness in financial reporting has

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6. SEC Accounting Series Release No. 153 (Feb. 25, 1974), 4 CCH FED. SEC. L. REP. ¶ 72,175, at 62,399.

communicated to the profession the Commission's expectation that accountants' responsibilities go beyond the mechanical application of defined accounting principles.

#### *D. Improving Public Confidence*

The Commission is aware of the overall impact on public opinion of the enforcement program, and to this end a major objective is to increase the level of public confidence in financial reporting. If this is to be achieved, there must be greater confidence in the accounting profession and in the reporting environment. The investor must be assured that redress will be achieved in situations where deficiencies are found to exist. While some accountants suggest that confidence in the public accounting profession would be enhanced if all actions against accountants were kept private and many were not brought at all, this is a short-sighted view. As the level of professional performance rises, the public must be persuaded that an overwhelming majority of public accountants do a good job and that in those cases where they do not, vigorous action will be taken by public agencies to call them to task. A cover-up of deficient professional performance, no matter how justified, will ultimately tend to erode rather than enhance public confidence.

Confidence in the SEC is an important part of this total package that also must be considered. If investors are satisfied that the Commission, as the principal regulatory agency in the area, is alert and effective in discovering abuses and bringing effective sanctions against those involved in significant wrongdoing, there will be an increase in the level of investor confidence in financial reporting. While it is conceivable that an excessive number of such suits might erode public confidence, the temporary building of confidence through a process of deluding the public as to the reality of the situation would be far more destructive when the facts of the matter finally emerge.

At the same time, the need for public confidence in the SEC serves as a deterrent against the Commission bringing enforcement actions in marginal cases where the auditor involved was guilty of a simple error in judgment that was not particularly egregious. Although such errors might create some legal responsibility to private litigants, it does not seem desirable for the Commission to bring an enforcement action every time it may conclude that an auditor has made a mistake.

### III. THE APPROACH

In deciding whether to institute an enforcement action, the

Commission considers the case in light of several major factors, including the seriousness of the professional deficiency and the extent to which the auditor had knowledge of what was happening. The Commission also considers the degree to which the auditor appeared to be an active participant in a scheme to mislead the public through artful or incomplete disclosure or through the creative selection of accounting principles designed to present a picture inconsistent with reality. All factors relevant to the particular case must be considered.

In this connection, it should be emphasized that there are many enforcement actions brought by the Commission involving deficient financial reporting in which auditors are not named as defendants. In fact, auditors are named only in a minority of such cases. The Commission does not have a policy of pursuing all professional deficiencies that can be found simply for the joy of the hunt. Selectivity in the use of resources and attention to the more serious cases are keys to an effective program.

Because of the selectivity in bringing cases, it must be recognized that the failure to name an auditor in a case does not necessarily represent an endorsement of the job done. The Commission sometimes concludes that while an auditor has done less than would have been hoped, the performance does not warrant a formal action. In such situations, the Commission sometimes instructs the staff to request that the management of the accounting firm involved come in for an informal conference. At such a conference, the management is advised that although no action is being instituted, the Commission does not feel that the level of performance in the case was up to the standards it believes the profession should achieve. The management is then questioned with regard to remedial actions taken by the firm to improve future performance. In this way, appropriate corrective action can be encouraged in marginal cases without formal proceedings.

#### A. *Sanctions*

The sanctions imposed in Commission proceedings must serve a remedial purpose for firms in which improvements in the quality of work can reasonably be anticipated. In other cases, it is necessary to protect the public from continued practice before the Commission by unqualified persons and firms. Some circumstances arise in which it must be concluded that the performance of particular individuals or firms is so deficient that their continued practice before the Commission in the public market place carries too great a risk

and hence is unacceptable. While small firms have more commonly been involved in such cases, a consistent pattern of deficient work by a large firm might lead to a conclusion that its continued practice would expose the public to greater risks than the Commission could reasonably deem to be acceptable.

1. *Rule 2(e) Action.*—In cases involving unacceptable performance, the Commission has the authority under Rule 2(e) of its Rules of Practice to bar an individual or firm from practice before the Commission.<sup>7</sup> It may also suspend the professional from Commission practice until an appropriate showing of fitness to practice has been made. The ultimate sanction of a permanent bar is not frequently used, since the Commission usually believes that a professional firm can take actions to bring its performance up to an acceptable level and provide the Commission with assurance that such a level is being maintained. Even when an accountant has been barred from practice before the Commission, his right to practice may be reinstated after the passage of time, usually upon a showing that he no longer poses a danger to the public.

2. *Quality Control Review and Inspection.*—Over the years the Commission has attempted to use sanctions which will meet the needs presented in each particular case. In the past two years, new sanctions have been developed in consent situations that the Commission believes hold some promise. Where cases raise questions concerning the adequacy of an accounting firm's quality control procedures, the Commission may require the firm to submit its procedures to the Commission's staff or to a group of outside professionals for review. As a result of this review, the firm and the Commission agree on certain quality control and audit procedures to be followed. Such procedures may emphasize particular areas of practice that relate to the specific enforcement action, but they are generally not limited to such areas. After agreement on procedures, the firm undertakes to have its subsequent practice inspected for a period of time by a group of its peers in professional practice to determine whether the standards are adequate and whether they are being implemented. This inspection team reports its findings to the Commission, which retains jurisdiction of the matter until the final report is received and evaluated. If the report is not satisfactory, further action is required. Although this sanction has a number of variants tailored to particular situations, it certainly is not a panacea, and may not be appropriate in every case. The Commission believes, however, that it will have the effect of promoting improved

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7. SEC Rules of Practice 2(e), 17 C.F.R. § 201.2(e) (1974).



professional performance, and has been working closely with the AICPA on this program.

In one case where this sanction was imposed, it appears that it had a beneficial effect in improving the firm's operating procedures and controls. In addition, the existence of an outside inspection team aided the senior management of the firm in upgrading the firm's professional practice. It is important, however, not to overemphasize the value of this program, because it is apparent that the attitudes of people and their training are of greater importance in assuring general audit excellence than are formal control procedures. Clearly, it is not productive to load a mountain of review on a pinhead of audit field work.

3. *Limiting New Firm Business.*—In addition to the inspection sanction, in some cases the Commission has imposed a partial or complete limitation on new SEC business for a firm, either for a prescribed period or until such time as a peer review group is able to inspect a practice and report thereon to the Commission. In this way the Commission feels it has obtained outside evidence that the program has been effectively implemented before the firm is allowed to grow further, either in the aggregate or in the areas that are affected most. Since the establishment of improved control procedures and the need for extended training of personnel will necessarily require the commitment of substantial managerial and personnel resources, it may be appropriate to require that when evidence of control problems arises, growth should be substantially curtailed until there is independent evidence that such problems are effectively eliminated. This seems particularly appropriate in cases where the problems have not been of a limited nature but have encompassed several areas of practice.

The Commission will continue to monitor the results of these sanctions and to appraise their success in achieving better financial reporting and auditing. As new situations are confronted that require different solutions, the Commission will try to develop additional approaches to the problem of sanctions.

### *B. Review of the Reviewers*

While it is appropriate to consider the Commission's enforcement program in terms of broad objectives, it is also important that the program be a fair one to specific firms and individuals affected in each separate case. I believe that adequate safeguards to insure fairness do exist in the procedures followed by the staff and the Commission, and although various parties may disagree with con-

clusions reached, the judgments made are based on a full consideration of the facts, including, if desired, written presentations from the proposed defendant.<sup>8</sup>

At each stage in the process of bringing a case, review of staff actions takes place at the Commission level. When the staff initially concludes that a situation warrants investigation to determine whether an enforcement action is needed, it must present the basis for this judgment to the Commission and request a formal order of investigation under which documents and witnesses may be subpoenaed. Such an order is not issued unless the Commission is persuaded that a reasonable basis exists for the investigation.

When an order is issued, the investigation is undertaken with due regard for the rights of all. Any person being questioned has the right to counsel and is fully informed of his rights by the staff. Accountants from the Division of Enforcement staff are involved early in the procedure when financial statements are part of the investigation.

In many cases, during the early stages of an investigation the staff is not fully aware of the facts that ultimately are developed and, accordingly, it is not always clear whether the professional accountant is a potential defendant. Nevertheless, where the professional accountant and his counsel seek information, the staff will attempt to advise them of the progress of the investigation to the extent it is feasible to do so. Moreover, during the course of the investigation the professional may make a submission setting forth his view of the case. Any submission made is furnished to the Chief Accountant and to the Commission. Representatives of the Office of the Chief Accountant are frequently consulted by the Division of Enforcement and regional office staffs as an investigation proceeds so that any questions concerning auditing and accounting can be answered in the course of the investigation.

Before a case involving an accountant is sent to the Commission, it is submitted to the Chief Accountant for review on the merits. At this time, the Assistant Chief Accountant (Investigations) in the Office of the Chief Accountant generally reviews the testimony and other evidence and reports his conclusion to the Chief Accountant. In many cases the proposed defendant will request a meeting with the Chief Accountant to discuss the case, and, if thought desirable by the staff, this meeting will be held before any recommendation is forwarded to the Commission. After careful review of the evidence, the Chief Accountant then makes his recom-

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8. 17 C.F.R. § 202.5 (1974).

mendation which is submitted to the Commission along with the recommendation of the Division of Enforcement. In my tenure with the Commission, no case against an accountant has been brought without my concurrence. If the case involves novel or particularly difficult questions, the Commission's Office of General Counsel will also review the recommendations.

After recommendations have been sent to the Commission together with any submissions by proposed defendants, the Commissioners and their legal assistants review the case with great care. The staff will frequently receive questions about details in connection with this review. Then the case is discussed at the Commission table before any decision is reached, and these discussions are substantive in nature. The staff is subjected to vigorous questioning, and the principles and objectives underlying the proposed action are considered in depth.

All of these procedures occur prior to an action being brought by the Commission, since it is recognized that the bringing of an action against a professional has a substantial impact on his reputation even before any judicial determination is made. After the action is brought, of course, the normal due process of the legal system is still available to provide protection against unjust actions.

While virtually all Commission cases are civil in character, on rare occasions it is concluded that a case is sufficiently serious that it should be referred to the Department of Justice for consideration of criminal prosecution. Referrals in regard to accountants have only been made when the Commission and the staff believed that the evidence indicated that a professional accountant certified financial statements that he knew to be false when he reported on them. The Commission does not make criminal references in cases that it believes are simply matters of professional judgment, even if the judgments appear to be bad ones.

#### IV. CONCLUSION

The Commission's enforcement program in regard to professional accountants is one of the means by which it seeks to improve the quality and reliability of financial reporting in the United States. Effective utilization of this program can achieve an increasing quality of professional performance and the implementation on an industry-wide basis of improved quality control procedures, thereby assuring the vitality of auditing standards and public confidence in the profession as a whole. These objectives are being achieved through a selective, albeit vigorous, application of enforce-

ment powers and the continued use of flexible and innovative approaches by the SEC. While the accounting profession may sometimes feel that it has been damaged by this effort, I am confident that in the long run the profession has in fact been strengthened in performing its essential function for the investing public and the free capital market system.

